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In the Supreme Court of the United States

OCTOBER TERM, 1966

No. 1215

R. A. BABCOCK AND NORMA L. BABCOCK, PETITIONERS

v.

V. LEE PHILLIPS

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

The issue presented by this tax case is whether the transfer of substantially all the operating assets of a state bank to a newly formed national bank, controlled by the stockholders of the state bank (principally petitioner), constituted a "D" reorganization within the meaning of 1954 Code § 368, so that the distribution of the state bank's accumulated earnings to its stockholders is taxable as a dividend under § 356(a)(2).

Petitioner[1] owned 800 of State Bank's 1,000 outstanding shares. In 1957 and 1958 the following plan

[1] Mrs. Babcock is a party only because joint returns were filed.

was carried out: Petitioner purchased the remaining 200 shares from State Bank's president and immediately resold 150 shares to five individuals. Petitioner and the five individuals formed a new national banking corporation and paid $250,000 cash to the National Bank, receiving in exchange all of its stock in the same proportions as their stock ownership in State Bank. State Bank's fiduciary assets (*i.e.*, its loans receivable, bonds, notes, bills and cash) amounting to approximately $3,800,000, were transferred to National Bank in consideration for the latter's assumption of the former's liabilities to depositors and others. State Bank retained ownership of the bank building, certain equipment and approximately $500,000 cash; it leased the building and equipment to National Bank rent free. State Bank then liquidated and distributed the cash and other retained assets to petitioner, who, having repurchased the 150 shares sold to the five individuals, was State Bank's sole stockholder. (Pet. 13–14.)

The net result of this series of steps was as follows: The banking business which had been operated by State Bank continued without interruption under a new corporate charter (National Bank) at the same location, with the same officers (except for State Bank's president), employees and stockholders, and with the same equipment. The shareholders of State Bank immediately before the transaction owned all the stock of National Bank immediately after the transaction (petitioner in fact owned 85 percent of each). Aside from the change in corporate charters, the only change of significance was that over $500,000

(mostly cash) of State Bank's accumulated corporate earnings had been paid to its shareholders. (Pet. 14–15.)

Petitioner reported the liquidating distributions received from State Bank in excess of his basis in its stock as capital gains ($83,450 for fiscal 1958 and $63,388 for fiscal 1959). The Commissioner determined that these gains were taxable as ordinary income under § 356(a). (Pet. 16.) The Commissioner's determination was upheld by the district court (R. 20).[2] The court of appeals affirmed (Pet. 12–18).

The decision below is correct. There is no conflict of decisions or other reason for review by this Court.

1. In general, if substantially all the assets of a corporation (here State Bank) are transferred to a new corporation (here National Bank) which is controlled by the transferor corporation or one or more of its stockholders, the transaction constitutes a "D" reorganization. 1954 Code §§ 368(a)(1)(D), 354(b) (App. *infra*, pp. 11–13). If the transferor corporation then liquidates and distributes retained assets (cash and other property) to its stockholders, this property constitutes "boot" and is taxed as a dividend to the extent of the earnings and profits, if it "has the effect of the distribution of a dividend." Code § 356(a)(2) (App. *infra*, p. 12).

The theory behind this treatment is as follows: State Bank could have been "converted into a national banking association" without the formation of a new corporate entity. 12 U.S.C. 35; see also 2

[2] "R." references are to the printed record in the court of appeals.

Colo. Rev. Stat., 1963 Ann., § 14–10–2 *et seq.* If State Bank had been "converted" into a national bank and had also distributed the cash and other assets while retaining its operating assets intact, the distributions would have been taxed to the stockholders as a dividend. Thus, when State Bank decided instead to transfer its operating assets to a new corporation (National Bank), which was essentially a continuation of State Bank, and also to distribute the cash and other assets to its stockholders, the distribution should result in taxable dividends, just as if the transfer from one corporation to the other had not taken place.

The Code accomplishes this result by taxing as a dividend property ("boot") distributed to shareholders incident to a reorganization. Petitioner argues, however, that even though the corporate banking business continued uninterrupted in the new corporate shell (National Bank), which was owned 100 percent by State Bank's shareholders, the instant transaction nevertheless does not constitute a reorganization and that he should be allowed to withdraw State Bank's undistributed profits—in the form of nearly $500,000 of cash, plus additional real estate and equipment—at the capital gains rate.[3]

(a) Notwithstanding that National Bank ended up owning substantially all the operating assets neces-

[3] If the transaction does not constitute a reorganization, 1954 Code § 331 dealing with complete liquidation (App., *infra*, p. 11) would apparently make petitioner's profit on the transaction a capital gain. If, on the other hand, the transaction is a reorganization § 331 is inapplicable. See *Commissioner v. Estate of Bedford*, 325 U.S. 283, 291.

sary to conduct the continuing banking business (R. 10–12, Pet. 14), petitioner contends (Pet. 6) that "substantially all of the assets" of State Bank were not transferred to National Bank, as required by Code § 354(b)(1)(A). He argues that State Bank did not transfer its approximately $3,800,000 of fiduciary assets to National Bank, but rather that State Bank "escrowed cash and securities aggregating $3,827,254.76 with National Bank in trust for the depositors," and that "[i]t was the State Bank depositors who * * * deposited their funds * * * in [*i.e.*, transferred their funds to] National Bank." The only way that State Bank could transfer its assets to the new bank under Colorado law was to transfer them to the new bank as trustee for the old bank's depositors. This method of effectuating the transfer of the old bank's business to the new bank was "no more than [an] intermediate procedural device utilized to enable the new corporation to acquire all the assets of the old one pursuant to a single reorganization plan"; such "[t]ransitory phases of an arrangement frequently are disregarded [under the corporate reorganization] sections of the revenue acts where they add nothing to the completed affair."[4] *Helvering* v. *Alabama Asphaltic Limestone Co.*, 315 U.S. 179, 184–185. Moreover, National Bank's assumption of State Bank's liability to depositors serves only to emphasize the continuity of the cor-

[4] Certainly, it was not the intent of Congress in enacting the reorganization and dividend provisions of the Code to accord the shareholders of, for example, reorganizing banks more favorable tax treatment than that accorded the stockholders of other corporations undergoing comparable reorganizations.

porate enterprise, and is incompatible with petitioner's contention that the business was "liquidated." See *Moffatt* v. *Commissioner*, 363 F. 2d 262 (C.A. 9), certiorari denied, April 24, 1967, No. 804, this Term; *Davant* v. *Commissioner*, 366 F. 2d 874 (C.A. 5), certiorari denied, April 24, 1967, No. 911, this Term; *Pridemark, Inc.* v. *Commissioner*, 345 F. 2d 35 (C.A. 4).[5]

(b) Petitioner also contends that even if substantially all the assets of State Bank were transferred to National Bank, the transaction did not qualify as a "D" reorganization because the stockholders purchased National Bank's stock for $250,000 rather than receiving it via a distribution from State Bank pursuant to the plan of reorganization. The courts, however, have long rejected such formalistic arguments and have held that when one corporation transfers its essential business enterprise to another corporation which is controlled by one or more of the transferor corporation's stockholders, the transaction constitutes a "D" reorganization, regardless of the form in which the transaction is cast. See, *e.g.*, *Lewis* v. *Commissioner*, 176 F. 2d 646 (C.A. 1); *Heller* v. *Commis-*

[5] Petitioner's reliance (Pet. 6) upon Rev. Proc. 66-34, 1966-34 Int. Rev. Bull. 22, is misplaced. As pointed out in our Brief in Opposition to Certiorari in *Moffatt* v. *Commissioner* (pp. 6-11), whether the "substantially all" requirement is satisfied is not to be determined by a mechanical application of any particular percentage test. Furthermore, that ruling states that it is not attempting to define the statutory terms but merely to announce the type of transactions which will "ordinarily" be given favorable advance rulings. Even if a percentage test were applied in this case, State Bank transferred approximately 90 percent of its assets to National Bank (R. 19).

sioner, 2 T.C. 371, affirmed, 147 F. 2d 376 (C.A. 9), certiorari denied, 325 U.S. 868; *Bard-Parker Co.* v. *Commissioner,* 218 F. 2d 52 (C.A. 2), certiorari denied, 349 U.S. 906; *Liddon* v. *Commissioner,* 230 F. 2d 304 (C.A. 6), certiorari denied, 352 U.S. 824; *Commissioner* v. *Morgan,* 288 F. 2d 676 (C.A. 3), certiorari denied, 368 U.S. 836; *Moffat* v. *Commissioner, supra; Davant* v. *Commissioner, supra.* Here, since the same persons owned all the stock of both State Bank and National Bank, it made no difference to them whether National Bank paid for State Bank's assets in part by issuing some of its own stock which was then distributed to State Bank's stockholders; this would merely have increased the number of shares of National Bank stock which they owned, but would not have effected any substantive change in their ownership. "To require the actual transfer of stock certificates where such a transfer would be a meaningless gesture would be to make the reorganization provisions optional with the taxpayer, a result which Congress clearly did not intend." *Davant* v. *Commissioner, supra,* p. 887. Accord: *Heller* v. *Commissioner, supra; Liddon* v. *Commissioner, supra; Commissioner* v. *Morgan, supra; Moffatt* v. *Commissioner, supra.*

Moreover, the result reached by the court of appeals prevents the use of the reorganization sections to escape taxation by converting into capital gains distributions which are in effect dividends out of accumulated earnings and profits, and is in accord with the announced objectives of Congress in enacting the corporate reorganization and related dividend provisions of the 1954 Code—namely, "to insure that

transactions which are in substance, although not in form; dividend distributions * * * are subject to tax at ordinary income rather than at capital gain rates." S. Rep. No. 1622, 83d Cong., 2d Sess., p. 42.[6]

2. Contrary to petitioner's contention (Pet. 7–8), neither the result reached by the lower court nor its reasoning is in conflict with any other decision. Petitioner relies primarily on *United States* v. *Arcade Co.*, 203 F. 2d 230 (C.A. 6), which is clearly distinguishable factually. In its later case of *Liddon* v. *Commissioner, supra,* the sixth Circuit, on facts very similar to those in the instant case, held the transaction to be a "D" reorganization and distinguished *Arcade* on grounds that are equally applicable here (230 F. 2d at 307).[7]

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[6] Contrary to petitioner's contention (Pet. 8–10), the decision of the court of appeals is not based upon a lack of business purpose for the transaction. The lower court merely volunteered its belief that, since it was unnecessary to create a new corporate entity and to liquidate the old corporation in order to convert the state bank into a national bank (see § 5154, Revised Statutes, as amended (12 U.S.C. § 35); 2 Colo. Rev. Stat., 1963 Ann., § 14–10–2 *et seq.*), the purpose of the transaction was to siphon off State Bank's unneeded accumulated earnings, and that for this reason the transaction should be closely scrutinized. In any event, if there was in fact a valid business reason behind the transaction, as seemingly urged by petitioner (Pet. 3–4, 8–10), this "tends to confirm, rather than contradict, a reorganization." *Grubbs* v. *Commissioner*, 39 T.C. 42, 51, and cases there cited.

[7] In *Liddon* the taxpayers (husband and wife) owned 80 percent of old corporation's stock; the 20 percent stockholder wanted to retire. Taxpayers organized a new corporation, purchased its stock for $25,000 cash, and had the new corporation purchase the old corporation's operating assets. The old corporation then redeemed the 20 percent stockholder's stock and

Two other cases cited by petitioner—*Commissioner* v. *Berghash*, 361 F. 2d 257 (C.A. 2), and *Gallagher* v. *Commissioner*, 39 T.C. 144—are clearly distinguishable because the courts held that the stockholders of the old corporation did not have 80 percent "control" of the new corporation. See Code § 368(c) (App. *infra*, p. 13). Here, on the other hand, the six stockholders of the old corporation owned all the stock of the new corporation and petitioner alone owned 85 percent of both corporations.

In *Pridemark, Inc.* v. *Commissioner*, 345 F. 2d 35 (C.A. 4), the court found that there was no plan to transfer the assets and business of the old corporation to any new corporation controlled by the taxpayers. Here, on the other hand, there is no question that the parties planned to and did transfer substantially all the operating assets of the State Bank to the National Bank which they had formed for that purpose and that the transaction "resulted in a reincarnation of the State Bank as National" with the State Bank's business continued by the National Bank "as a going concern" (Pet. 18).[8]

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liquidated, distributing more than $150,000 in cash and notes to the taxpayers. The Sixth Circuit held this transaction—which is very similar to the instant case—to be a "D" reorganization.

[8] *First National Bank in Walsenburg* v. *Commissioner*, decided October 28, 1965 (P-H Memo T.C., par. 65,286), is inapposite. That case involved the question whether the new corporation was liable as a transferee for the debts of the old corporation. The court, without ever reaching the question whether the transfer of the assets from the old to the new corporation constituted a reorganization, held that there was no transferee liability because the new corporation paid full and adequate consideration for the assets.

3. Petitioner in the instant case presents substantially the same arguments as were presented by the taxpayers in *Moffat* v. *Commissioner,* No. 804, this Term, *Reef Corporation* v. *Commissioner,* No. 1005, this Term, and *Davant* v. *Commissioner,* No. 911, this Term, in all of which cases the Court denied certiorari on April 24, 1967. The considerations which led this Court to deny review in those cases are equally applicable here, and call for the same result.

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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MAY 1967.

APPENDIX

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 316. DIVIDEND DEFINED.

(a) *General Rule.*—For purposes of this subtitle, the term "dividend" means any distribution of property made by a corporation to its shareholders—

(1) out of its earnings and profits accumulated after February 28, 1913, or

(2) out of its earnings and profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

Except as otherwise provided in this subtitle, every distribution is made out of earnings and profits to the extent thereof, and from the most recently accumulated earnings and profits. * * *

* * * * * *

SEC. 331. GAIN OR LOSS TO SHAREHOLDERS IN CORPORATE LIQUIDATIONS

(a) *General Rule.*—

(1) *Complete liquidations.*—Amounts distributed in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock.

* * * * * *

SEC. 354. EXCHANGES OF STOCK AND SECURITIES IN CERTAIN REORGANIZATIONS.

(a) *General Rule.*—

(1) *In general.*—No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursu-

ance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

* * * * *

(b) *Exception.*—

(1) *In general.*—Subsection (a) shall not apply to an exchange in pursuance of a plan of reorganization within the meaning of section 368(a)(1)(D), unless—

(A) the corporation to which the assets are transferred acquires substantially all of the assets of the transferor of such assets; and

(B) the stock, securities, and other properties received by such transferor, as well as the other properties of such transferor, are distributed in pursuance of the plan of reorganization.

* * * * *

SEC. 356. RECEIPT OF ADDITIONAL CONSIDERATION.

(a) *Gain on Exchanges.*—

(1) *Recognition of gain.*—If—

(A) section 354 or 355 would apply to an exchange but for the fact that

(B) the property received in the exchange consists not only of property permitted by section 354 or 355 to be received without the recognition of gain but also of other property or money,

then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.

(2) *Treatment as dividend.*—If an exchange is described in paragraph (1) but has the effect of the distribution of a dividend, then there shall be treated as a dividend to each distributee such an amount of the gain recognized under paragraph (1) as is not in excess of his ratable share of the undistributed earnings and

profits of the corporation accumulated after February 28, 1913. The remainder, if any, of the gain recognized under paragraph (1) shall be treated as gain from the exchange of property.

* * * * *

SEC. 368. DEFINITIONS RELATING TO CORPORATE REORGANIZATIONS.

(a) *Reorganization.*—

(1) *In general.*—For purposes of parts I and II and this part, the term "reorganization" means—

* * * * *

(D) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor, or one or more of its shareholders (including persons who were shareholders immediately before the transfer), or any combination thereof, is in control of the corporation to which the assets are transferred; but only if, in pursuance of the plan, stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under section 354, 355, or 356;

* * * * *

(F) a mere change in identity, form or place of organization, however effected.

* * * * *

(c) *Control.*—For purposes of part I (other than section 304), part II, and this part, the term "control" means the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation.

U.S. GOVERNMENT PRINTING OFFICE: 1967